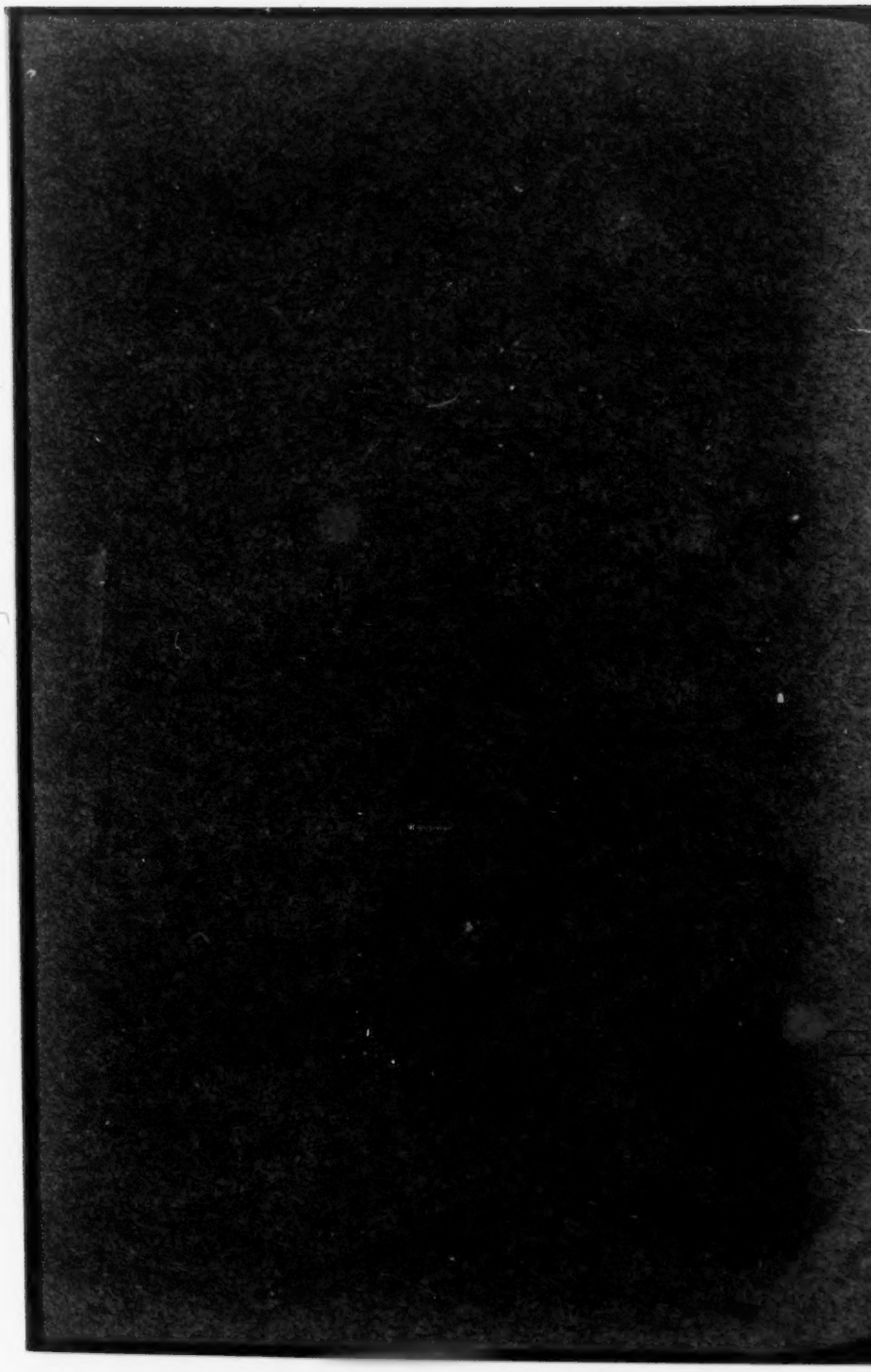

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In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 758

NORTH AMERICAN BOND TRUST, CITY BANK FARMERS TRUST COMPANY, TRUSTEE, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 166–178) is not reported. The opinions of the Circuit Court of Appeals (R. 197–210) are reported in 122 F. (2d) 545.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered August 30, 1941. (R. 211.) The petition for a writ of certiorari was filed November 24, 1941. The jurisdiction of this Court is invoked

under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Is a management type, open-end investment trust an association taxable as a corporation within the meaning of the definition appearing in Section 801 (a) (2) of the Revenue Act of 1934?

STATUTE AND REGULATIONS INVOLVED

The applicable statutes and regulations will be found in the Appendix, *infra*, pp. 11–15.

STATEMENT

The taxpayer is an investment trust of the management, open-end type. It was created by a trust agreement, dated as of September 1, 1932, between Distributors Group, Incorporated, as Depositor, the City Bank Farmers Trust Company, as Trustee, and the registered holders from time to time of certificates to be issued under the agreement.[1] (R. 22–23.) The agreement provides that the Depositor shall deposit with the Trustee a number of bonds conforming to certain detailed standards. (R. 23, 39–46.) The Depositor was given discretion in the selection of the eligible bonds to be included in the portfolio, and to determine when they should be eliminated upon becoming inappropriate

[1] The trust agreement was amended in 1933 in a minor respect. (R. 79–80.) The discussion herein is addressed to the situation appearing after the amendment.

for the purposes of the trust. In 1936 bonds issued by 131 different debtors were held by the Trustee. (R. 135, 137, 139.)

The Trustee was authorized to issue, for sale to the public, certificates representing in the aggregate ownership of 360 equal undivided equitable interests in all the property originally deposited by the Depositor. Each such certificate was to be registered in the name of the purchaser. (R. 24, 167.) The Depositor could deposit additional bonds from time to time, and the Trustee was then to issue new certificates, which would also represent equal undivided interests in all the deposited property. (R. 167.) With each deposit, miscellaneous sums of cash were added to the "currently distributable funds". (R. 168.)

All the interest, earnings, and other income from the deposited property were included with "currently distributable funds" (R. 47), as were all amounts realized from sales and maturities of bonds held in the portfolio (R. 169). None of such funds could be reinvested in bonds, but portions were to be distributed to certificate holders twice yearly. (R. 169, 171, 176.) The trust was to continue for 20 years from the date of its creation, but any time prior thereto a certificate holder could surrender his certificate and receive in cash from the Trustee his proportionate share of the then market value of his interest. (R. 172.) This right to surrender could be freely assigned by a

certificate holder, although such assignment would not carry with it the right to receive regular semi-annual distributions, unless the transfer was by operation of law, by death of the holder, or to or by the Depositor. (R. 32–33.) During the fiscal year ended August 31, 1936, the year involved herein (R. 166), the taxpayer realized $97,918.28 as capital gain from the sale of bonds and $287,-931.10 from interest. The total capital gain realized on the sale of bonds was $125,397.26, but losses on some of the bonds reduced the net capital gain. (R. 17, 174.) During the taxable year the Trustee had received from the Depositor bonds having a principal amount of $1,621,000 for the creation of new interests. At the end of the year, the bonds in the portfolio had an aggregate book value of $6,266,340.77. (R. 18.)

The trust agreement contained provisions relieving the Depositor and the Trustee of liability for certain defaults and misconduct. (R. 58–59, 172–173.) No meetings of certificate holders were held, nor could they vote. (R. 175.) The agreement could be modified or amended by the Trustee and Depositor without the consent of certificate holders as long as the substantial rights of the latter were not adversely affected. (R. 174.)

The Commissioner sent a notice of deficiency in income taxes for the fiscal year ended August 31, 1936, holding that the trust was an association taxable as a corporation. (R. 175.) The Board held

that it was not an association (R. 178), and the Commissioner appealed. The Circuit Court of Appeals reversed. (R. 211.)

ARGUMENT

1. The taxpayer urges that the question whether an investment trust is an association taxable as a corporation involves an important problem of federal law which should be settled by this Court.[2] Although the precise question has never been decided by this Court, nevertheless the principles to be followed in determining the answer are clearly set forth in *Morrissey* v. *Commissioner,* 296 U. S. 344; *Swanson* v. *Commissioner,* 296 U. S. 362; *Helvering* v. *Combs,* 296 U. S. 365; *Helvering* v. *Coleman-Gilbert,* 296 U. S. 369, and *Lewis & Co.* v. *Commissioner,* 301 U. S. 385. Further elucidation of these principles would seem unnecessary where the various circuit courts of appeals do not render conflicting decisions in applying them to similar facts.

2. The petitioner suggests (Pet. 10) that the decision below conflicts with the decisions in other cases involving investment trusts. *Hamilton Depositors Corporation* v. *Nicholas,* 111 F. (2d) 385

[2] The question will not arise in the same circumstances for the year 1938 and thereafter if an entity can qualify as a "mutual investment company," defined in Section 48 (e) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, and Section 361 of the Revenue Act of 1938, c. 289, 52 Stat. 447, and of the Internal Revenue Code (U. S. C. Supp. V, Title 26, Sec. 361).

(C. C. A. 10th); *Brooklyn Trust Co.* v. *Commissioner*, 80 F. (2d) 865 (C. C. A. 2d); *Investment Trust of Mutual Investment Co.* v. *Commissioner*, 71 F. (2d) 1009 (C. C. A. 2d); *Continental Bank & Trust Co.* v. *United States*, 19 F. Supp. 15 (S. D. N. Y.); *Commissioner* v. *Chase Nat. Bank*, 122 F. (2d) 540 (C. C. A. 2d); *Equitable Trust Co.* v. *Magruder*, 37 F. Supp. 711 (Md.). However, in the first four of those cases it was held, as here, that the trusts were associations taxable as corporations. No conflict is possible as to those decisions. *Equitable Trust Co.* v. *Magruder, supra,* is not in point, because it did not involve the question of the classification of an investment trust. The taxpayer in that case was a trustee holding installments paid toward the purchase price of the certificates of the underlying trust.

Petitioner asserts that the decision below conflicts with the decision, rendered on the same day by the same court in *Commissioner* v. *Chase Nat. Bank, supra.* However, the distinction found by Judge Learned Hand, and described in his opinion in the instant case, demonstrates that there is no necessary conflict. The discretion lodged in the Depositor herein to select any bonds conforming to a given standard is clearly broader than the discretion held by the Depositor in the *Chase Nat. Bank* case, where the Depositor's only discretion was to decide on the elimination of securities deemed inappropriate. Even this discretion could

be exercised only under the two supplemental agreements. Although the Commissioner argued in the court below that all investment trusts should be deemed associations, clearly the different results there reached are not inconsistent, since the trust agreements are not identical. The differences are not "formal variations in mere procedural details" (*Helvering* v. *Coleman-Gilbert*, *supra*, at p. 373), but are sufficient to warrant the Securities and Exchange Commission's classification of the entity involved herein as an "open-end management company", while the entities involved in the *Chase Nat. Bank* case are classified as "unit investment trusts". Securities and Exchange Commission Release Nos. 13 and 21 of Investment Company Act of 1940.

The decision below does not conflict with the principles established in the decision of this Court in *Morrissey* v. *Commissioner, supra*. The trust here had all the formal characteristics which were set forth as indicative of the requisite corporate resemblance which renders an entity an association. Centralized management of a common enterprise of a large group of associated persons was present. The trust agreement resembled a corporate charter, while the Depositor stood in the place of the directors of a typical corporation, and the Trustee resembled the officers. The interests of the participants, represented by certificates similar to shares of corporate stock, were transferable and could be

sold to the Depositor (R. 172) or on the over-the-counter market. Limited liability and continuity despite the death of a certificate holder were present. Certain characteristics typical of corporations were absent, but none were essential. Cf. *Helvering* v. *Coleman-Gilbert, supra; Swanson* v. *Commissioner, supra; Helvering* v. *Combs, supra.* Furthermore, the enterprise had a business purpose, found in the intention to enable the participants to obtain income and profits from their investments.

Article 801-2 of Treasury Regulations 86, promulgated under the Revenue Act of 1934, provides that both fixed and management type investment trusts shall be classified as associations. This eliminates the need for such "explication" as was necessary in the *Morrissey* case to determine whether the entity was covered by the intendment of the regulations. 296 U. S. at p. 356. The regulation should be controlling. Cf. *Textile Mills Securities Corp.* v. *Commissioner,* No. 34, present Term.

There is no conflict with *Lewis & Co* v. *Commissioner, supra.* In that case there were no certificates of interest, nothing analogous to a board of directors, and the whole enterprise was undertaken only for the liquidation of particular property. Nor is there any conflict with *Commissioner* v. *Gibbs-Preyer Trust Nos. 1 & 2,* 117 F. (2d) 619 (C. C. A. 6th), in which three children of a testator

established a trust to hold and manage property left by will. Such an entity is clearly more like a family type trust than a corporation, and is entirely unlike a typical investment trust.

3. The amendment of the regulations to include investment trusts specifically under the definition of associations is clearly within the power of the Commissioner. The letter of the Commissioner advising the petitioner that it was taxable as a strict trust (R. 83–84) was issued prior to the decision of the *Morrissey* case. Clearly it could not bind the Government in the face of decisions of this Court establishing the principles to be followed in cases of this type. This is abundantly supported by the discussion of regulations in the *Morrissey* case itself. See also *Estate of Sanford* v. *Commissioner,* 308 U. S. 39. Furthermore, the letter expressly stated that the ruling was subject to change if warranted by future developments in the law. (R. 84.) No question is presented for decision by this Court in the petitioner's discussion of this point.

4. The petitioner's final point is that the court below, pursuant to rules established by decisions of this Court, had no power to reverse the decision of the Board, which was based on a finding that the entity was not carrying on a business enterprise. However, where the facts are not in dispute it is clear that a decision of the Board on the question of classification of an entity as an association

or a strict trust is a question of law which may be reviewed on appeal. Compare *Helvering* v. *Combs, supra,* where this Court reversed a decision of the Circuit Court of Appeals affirming the Board in holding that an entity was not an association. Cf. *United States* v. *Pyne,* 313 U. S. 127

CONCLUSION

There is no conflict. The decision below is correct. The petition should be denied.

Respectfully submitted.

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DECEMBER, 1941